RH105-19.36A

Research Bulletin

Pay & Performance: The Interaction of Compensation & Performance Appraisal

by Charles Peck

The Conference Board

number 155

© 1984 The Conference Board, Inc.

THE CONFERENCE BOARD, INC.
845 Third Avenue, New York, N.Y. 10022
THE CONFERENCE BOARD OF CANADA
25 McArthur Road, Ottawa, Ontario, K1L-6R3, Canada
THE CONFERENCE BOARD, INC.
Avenue Louise, 207-Bte 5, B-1050 Brussels, Belgium

Introduction

Since the time of the early Puritan settlers, it has been part of the American work ethic that effort should—and will—be rewarded. The pay-for-performance concept that employees should be monetarily rewarded for conscientious effort has been somewhat battered over the passage of time by such opposing forces as egalitarianism. However, it remains the cornerstone of U.S. corporate compensation philosophy.

The pragmatic argument for this philosophy is twofold: First, differences in performance can be discerned; and, second, superior performance is reinforced by pay increases. Corporate belief in the importance of individual performance as a determinant of pay increases was documented in a 1981 Conference Board study in which almost 95 percent of the companies surveyed rated it the most important factor in determining exempt and executive pay increases, and practically 90 percent said it was the most important factor in pay raises for nonexempt salaried employees.[1]

Opposing the notion of performance-based pay is the idea of egalitarianism. Egalitarianism emerged from the eighteenth century antimonarchical concepts of Condorcet and Rousseau, and was exemplified by Jeffersonian democracy. Thus its philosophical and historical roots are also venerable.

In the U.S. business arena, the egalitarian standard is carried chiefly by unions, which negotiate with management for pay increases covering whole groups of employees, largely irrespective of individual, or even group, performance. The contention of organized labor is that performance-based pay systems are too prone to abuse and can easily become vehicles for favoritism and "rate busting."

As a result, most corporations focus their pay-for-performance effort on exempt employees, since hourly wage increases are usually either collectively negotiated or, in nonunion establishments, follow the pattern of jointly bargained agreements. This leaves exempt exployees: a very heterogeneous group embracing supervisors, scientific and professional employees, sales representatives, administrative personnel, managers and top executives. In fact, one problem in applying the pay-for-performance concept to exempt employees is posed by the difficulty in measuring the performance of some of these subgroups.

An exception to this general practice is the use of productivity incentives by some firms. However, the incidence of these plans does not seem to be widespread.[2] Nonexempt salaried employees occupy a middle ground. The performance factor in their pay raises tends to be more diluted than in the case of exempt employees' increases by considerations such as economic changes, the influence of collectively bargained agreements, and the effect (up to a point) of seniority on performance, which makes salary increases, in effect if not in fact, "step-rate" pay progression.

Production engineers have long been able to measure the output of direct labor in relation to its cost. With respect to nonexempt salaried employees, such as clerical workers, there has been progress, particularly in the insurance and banking industries, in the development of measured clerical work standards similar to those used for production employees. The performance of certain segments of the exempt group lends itself to reasonably concrete measurement. For example, the productivity of a first-line production supervisor's unit is assumed to correlate with his or her performance as a supervisor. The sales volume generated by field sales representatives is a direct measure of their performance. In the case of top executives, it has long been assumed that their performance can be directly related to corporate profitability, and thus measurable in terms of the balance sheet. This assumption underlies the annual top-executive bonus plan. However, it is very difficult to correlate the performance of administrative, staff and professional exempt employees with quantifiable results. Their value as employees—and thus their performance—can often only be related to the intangible "management of the organization."

This study concentrates on pay for performance for exempt employees in general, excluding field sales representatives and, largely, top executives. Both of these groups were considered in prior reports.[3]

[1]Charles A. Peck, *Compensating Salaried Employees During Inflation: General vs. Merit Increases.* The Conference Board, Repo.. No. 796, 1981.

[2]For a study of productivity incentive plans, see *Productivity Sharing Programs: Can They Contribute to Productivity Improvement?* Washington, D.C.: U.S. General Accounting Office, March 3, 1981.

[3]Charles A. Peck, *Compensating Field Sales Representatives.* The Conference Board, Report No. 828, 1982. Harland Fox, *Top Executive Bonus Plans.* The Conference Board, Report No. 760, 1979; *Executive Incentives: Long Term Performance Share/Unit Plans.* The Conference Board, Research Bulletin No. 132, 1983; *Executive Incentives: Incentive Stock Option Plans.* The Conference Board, Research Bulletin No. 148, 1983.

Table 1: Numbers of U.S. and Exempt Employees, by Industry Category

Industry Category	Total U.S. Employees			Exempt Employees		
		Middle 50 Percent Range			Middle 50 Percent Range	
	Median	Low	High	Median	Low	High
Manufacturing	9,600	3,220	26,000	2,120	800	6,000
Banking	1,240	640	2,550	360	160	690
Insurance	1,300	770	4,200	450	240	1,490
Diversified finance	3,850	1,770	9,600	1,100	550	3,670

Methodology

The data for this study were obtained through a mailed questionnaire sent, in most cases, to compensation executives in a cross section of manufacturing companies, banks, insurance companies, and diversified financial institutions. After the survey results had been analyzed, a participative research seminar was held, attended by a small number of survey participants who discussed, clarified and amplified these results. In a few cases, additional information was obtained (or existing information was clarified) by telephone interviews. Questionnaires were received from 557 companies distributed among the four industry categories as follows:

Industry Category	Number of Companies
Manufacturing	302
Banking	145
Insurance	95
Diversified finance	15
Total	557

Table 1 shows the total number of U.S. employees and the number of exempt employees for each industry category. Table 2 gives information on financial size for each of the four groups.

Pay for Performance

This section summarizes some views in favor of pay for performance, examines its importance as a compensation objective, and gives an indication of perceived success or failure in achieving it.

Pay-for-Performance Advocates

The proponents of pay for performance are found mostly in those organizations either attempting it or at least saying they are attempting it. Endorsements of pay for performance often appear in corporate policy statements of pay-policy objectives. The extent of corporate belief in pay for performance was indicated by a survey conducted by the employee benefit and compensation consulting firm, William M. Mercer, Inc., in which chief executive officers in 63 percent of 305 companies surveyed said their company's pay and benefits policies were designed to reinforce corporate values, of which performance was the most highly prized.[1] Pay for performance recently received a boost from the White House, when the Administration proposed regulations for the first time tying pay increases to performance for 1.4 million federal civilian workers.[2]

[1]William M. Mercer, Inc., Reported in *Industrial Relations News*, October 22, 1983.

[2]Reported in *The New York Times*, October 25, 1983.

Following are some typical references to pay-for-performance philosophy from company policy statements:

"Individual compensation is to be based on the individual's contribution to the success of the company. The salary system will be internally fair and externally competitive, rewarding outstanding job performance based upon objective measures agreed to in advance between the individual employee and his (or her) superior. Appraisal of individual job performance is to be determined by a formal, objective system clearly understood by all employees and which will, to the greatest extent possible, identify individual progress with company success."

—An Insurance Company

"Rewarding individual employees is a vital part of effective performance management. Employees must know that rewards will come in proportion to the level of performance on the job. This knowledge helps assure people that the system is both fair and responsive to their efforts. In addition, consistent recognition and rewards for performance are among the manager's most powerful motivational tools."

—A Bank

"Merit increases within a salary grade range should be granted only in recognition of meritorious performance. They should not come as a matter of course, and should be planned and scheduled in such a manner as to avoid

Table 2: Company Size, 1982, by Various Financial Criteria

Industry Category	Criterion	Size (millions)		
			Middle 50 Percent Range	
		Median	Low	High
Manufacturing	Sales volume	$1,027	$371	$3,255
Banking	Total deposits	1,043	632	2,578
Insurance	Total premium income	256	142	1,057
Diversified finance	Total income	1,003	244	2,337

any connotation of being an economic adjustment or annual raise. Increases should be proposed when performance and productivity clearly indicate that payment in a higher area of the range is warranted."

—A Cosmetics Company

"Current salaries and the salary progress of employees should reflect their performance. An effective salary-administration program requires that differences in performance among employees with similar responsibilities reflect differences in salaries paid. This means that employees who perform their assigned tasks in a superior manner can expect to receive salary increases that are above average. Likewise, employees who are fair-to-poor performers can expect to receive average salary increases or none at all. Continued below-satisfactory performance will lead to either delayed or reduced salary adjustments."

—A Toy Manufacturing Company

Research by Professors Richard E. Kopelman and Leon Reinharth of Baruch College (City University of New York) supports the effectiveness of pay for performance as a motivation for salaried employees.[3] Based on a study of approximately 1,000 white-collar employees in the branch offices of a financial enterprise, research results were highly supportive of the hypotheses that the stronger the performance-reward tie, the higher the level of subsequent performance, and that an expanded range of possible merit salary increases yields a higher level of overall performance.

Pay for Performance as a Compensation Objective

There are a number of possible compensation program objectives including: paying for performance; paying competitively; establishing and maintaining equitable internal pay relationships; controlling payroll costs; providing fair and consistent methods for pay increase opportunities; and recognizing and adjusting for economic changes. A number of companies have formally stated the objectives of their pay systems, very often in employee-communication documents on compensation and performance appraisal. Two typical statements of compensation objectives follow:

"With thousands of employees working at hundreds of different kinds of jobs, we must have a systematic way to make sure that employees are paid fairly and that salary dollars are spent wisely. That's why we have a salary administration program. It's designed to analyze jobs, research salary information, and provide supervisors with guidelines for making sound salary decisions.

"The goals of our salary program are to: attract qualified people; motivate employees to improve their performance and to do their best work; reward high levels of job performance; and maintain payroll costs at competitive levels.

"To accomplish these goals, salary ranges are established for all jobs to be competitive in the appropriate job market. Your pay within the salary range for your job is based primarily on your individual performance."

—A Bank

"The main goal of our pay program is to help attract, motivate and retain the most competent people available. To do this, the program has to meet several objectives. It must: establish pay levels that accurately reflect the relationships between different positions in the company; make sure overall pay levels are competitive with those of other leading companies; assure that individual pay levels reflect individual contributions; provide a method for granting increases that is consistent throughout the company; and stimulate the best efforts of each employee."

—A Diversified Manufacturing Company

The survey participants were asked to select from a list of compensation-program objectives the ones they considered "very important." Table 3 (on page 6) shows the frequency with which the various objectives were rated "very important" by the entire sample. Separate industry categories are not shown, since there was little variation from all-company data.

There is no doubt about the importance of paying for performance as a compensation objective in the minds of the survey respondents. Eighty-six percent (477) of the 557 companies in the entire sample rated it as a very important objective of their compensation programs, with approximately the same proportion of each industry category doing so.

Maintaining equitable relationships among jobs was rated "very important" with the second most frequency, mentioned by 54 percent (298) of all the companies. This same relationship held true for all industry groups except

[3]Richard E. Kopelman and Leon Reinharth, "Research Results: The Effect of Merit-Pay Practices on White Collar Performance." *Compensation Review*, Fourth Quarter, 1982.

for banking, where "providing a consistent method for granting pay increases" was the second most highly rated objective.

The objective *least frequently* designated "very important" was adjusting for economic changes. In spite of this, however, a question does exist about the immunity of exempt compensation systems from economic influences. Data indicate that when inflation is high, the size of exempt pay increases tends to rise after a lag of about one year. For example, in 1977 through 1979, median exempt merit increases, according to a Conference Board study, were 8 percent each year.[4] The Consumer Price Index for the same period showed a pattern of increases culminating in a 13.3 percent rise in 1979 over 1978.[5]

In 1980, a check by The Conference Board of a selected sample of companies showed an average exempt merit increase of 9 percent. In addition, a number of cost-of-living-adjustment (COLA), "other" and one-time general increases in response to inflation caused the 1980 total average increase to rise to 11 percent.

In the present environment, marked by a comparatively low rate of inflation, merit increases are remaining correspondingly low. The American Compensation Association reports a 1984 projected merit increase for exempt employees of 6.6 percent.[6] The conclusion is inescapable that while economic adjustments may not be an important *stated* objective of most corporate compensation programs, the state of the economy has implications for the validity of pay for performance, particularly in times of high inflation.

Where Pay for Performance Is Not a Compensation Objective

Six companies said that pay for performance was *not* a stated objective of their compensation programs. However, none of these companies flatly expressed disbelief in the concept of pay for performance or said that the results would not be worth the effort.

Five of the six reported that they had no formal program for achieving pay for performance but did believe in the concept. Two of the five, both diversified financial companies, indicated that, in the past, their industry tended to take an informal approach to compensation and performance appraisal. One said, however, that it was currently in the process of developing a formal system. The other said it would consider a formal system as the number of employees increased. The third company, a bank, said that while it had no formal system, it believed in paying for performance and relied on the judgment of its managers to differentiate pay increases on the basis of performance. The fourth company was a manufacturer, responding in terms of its headquarters location. It said that because of high diversification and a small corporate exempt staff, it had no formal corporate pay-for-performance system. The respondent implied, however, that the company tried to achieve pay for performance on an informal basis. The fifth, also a manufacturing company, merely stated that it had not officially defined its compensation goals. Based on the complete survey form, however, it appeared that it also tried informally to achieve pay for performance.

The sixth respondent, an insurance company, came closest to having an alternative to paying for performance: "Because the bulk of the salary increase has been on a cost-of-living basis and top people are hired at very competitive salaries, and a high uniform level of productivity is demanded, there is little performance distinction made among the top 95 percent of employees."

Table 3: Importance of Objectives of Corporate Compensation Programs

Objective	*Number of Companies Rating Objective "Very Important"*[1]
Pay for performance	447
Maintain equitable relationships among jobs	298
Provide consistent method for granting increases	268
Keep payroll costs competitive	198
Ability to hire	183
Adjust for economic changes	53

[1]557 companies responding; multiple answers.

Successes and Failures of Pay-for-Performance Systems

Survey respondents were asked to evaluate the effort to pay for performance. Table 4 shows the results.

Of the 521 companies answering the question, 82 percent (429) thought their effort to pay for performance had been successful to at least some degree. In terms of the four industry categories, the highest perception of success was shown in the very small sample of diversified finance companies, and the lowest in manufacturing.

In order to make a distinction among the successful programs, companies were asked to specify the degree of success achieved. Table 5 shows the survey participants' estimation of their degree of success.

The majority of respondents (55 percent overall) reported moderate success, with the specific industries ranging from 54 percent (manufacturing) to 62 percent (insurance). More reported very successful programs (26 percent overall) than reported marginal success (9 percent overall).

[4]Peck, Report No. 796, 1981.

[5]Bureau of Labor Statistics, U.S. Department of Labor.

[6]*1983-1984 Salary Budget Survey*, The American Compensation Association, Scottsdale, Ariz. October, 1983.

Table 4: Success of Pay for Performance, by Industry Category

Industry Category	Rating of Pay for Performance					
	Successful		Not Successful		Cannot Tell	
	Number	Percent	Number	Percent	Number	Percent
Manufacturing (N = 284)	224	79%	54	19%	6	2%
Banking (N = 140)	119	85	18	13	3	2
Insurance (N = 86)	76	88	10	12	—	—
Diversified finance (N = 11)	10	91	1	9	—	—
Total (N = 521)	429	82%	83	16%	9	2%

Table 5: Degree of Success of Pay for Performance, by Industry Category

Industry Category	Degree of Success							
	Very Successful		Moderately Successful		Marginally Successful		Cannot Tell Degree of Success	
	Number	Percent	Number	Percent	Number	Percent	Number	Percent
Manufacturing (N = 193)	50	26%[a]	105	54%	18	9%	20	10%
Banking (N = 96)	27	28[a]	50	52	9	9	10	10
Insurance (N = 65)	14	22[a]	40	62	7	11	4	6
Diversified finance (N = 9)	3	33	5	56	—	—	1	11
Total (N = 363)	94	26%	200	55%	34	9%	35	10%

[a]Percentages do not add to 100 because of rounding.

On the other side, Table 4 shows that 16 percent (83) of the 521 companies responding said their programs had failed. Manufacturers reported the most failures and diversified financial companies the fewest. The last section of this study compares in detail the two extremes: systems perceived as successful and those viewed as unsuccessful.

Criticisms of Pay for Performance

The major views critical of pay for performance are summarized in this section along with an indication of how employees feel about the subject.

The Critics

There is no lack of criticism of the present state of pay for performance. Much of this centers on the way organizations attempt to achieve it through salary increases, especially in regard to the performance appraisal process, which is the basis for most exempt salary actions in the formal pay systems.

However, Herbert H. Meyer, former Manager of Personnel Research at General Electric and presently an academic, has criticized reward theory—the whole basis of corporate compensation systems.[1] Meyer believes that to the extent pay is directly attached to the performance of a task, intrinsic interest in the task itself declines. When pay becomes the important goal, the individual's interest tends to focus on it rather than on the performance of the task. Meyer uses the example of parents who fall into the trap of paying their children to do chores they should be expected to do in any case.

Meyer further contends that merit-pay plans can pose a threat to employees' self-esteem. In his research on the performance appraisal process at General Electric, Meyer asked professional and managerial personnel to rate their own performance in comparison with that of others on a percentile scale ranging from 100 (if they believed they were performing better than anyone else in a similar job at a similar salary level) to 0 (if they believed their performance was worse than that of all their peers). The middle rating, 50, represented average performance.

The average self-rating was at the 77th percentile on the scale; and over 90 percent rated themselves above average. When the supervisors of these employees were asked to rate the same people on the same scale, the average rating was at the 66th percentile. When the two sets of ratings were compared, 85 percent of the employees had been rated lower by their managers than they rated themselves.

[1]Herbert H. Meyer, "The Pay-for-Performance Dilemma." *Organizational Dynamics*, Winter, 1975.

Meyer's implication is that since employees tend to rate their own performance higher than do their supervisors, they are always going to believe their merit increases do not reflect their true worth as employees. Their perceptions of themselves as above-average performers may be at the root of most of the problems with merit-pay plans, according to Meyer, since the majority of employees will always be dissatisfied with their pay raises.

The reaction by employees to this threat to their self-esteem posed by the appraisal process is not, Meyer says, an increased effort to improve performance in order to get a bigger increase next time. Instead, he cites such negative reactions as trying to get the performance standards lowered; downgrading the importance of the activity, which shows up in tardiness, absenteeism and decreased productivity; and disparaging the source of the threat to self-esteem by questionning the competence of the supervisor. In this connection, Meyer's research shows that the majority of employees expressed more unfavorable opinions of their supervisors after a performance appraisal and salary review than did before.

Finally, Meyer believes pay-for-performance plans foster an unhealthy competition among employees, since they must vie against each other for a limited budget of salary-increase dollars. The resulting win-or-lose situation produces such reactions as: Competitors are seen as enemies and hostility develops; perception of one's self becomes distorted positively, while perception of competitors is negatively distorted; and interaction and communication decrease to the detriment of the organization's goals.

The late Douglas McGregor, who was Sloan Professor at the Sloan School of Management, MIT, long since raised unanswered questions about the criteria for measuring the individual employee's performance.[2] According to him, such criteria are made the basis for overly fine distinctions among individuals. For example, one employee gets a 3 percent salary increase, another 6 percent, and a third 10 percent. It is most likely that the probable error of measurement of performance is several times the magnitude of the differentials being made. Further, McGregor held that the use of such comparatively small reward increments is not especially effective as a motivator.

In a similar vein, Nathan Winstanley, former Compensation Research Manager at Xerox and presently a consultant and academic, believes that assigning ratings to any more than three performance categories is asking managers to make finer distinctions than they can (or will) do.[3] According to Winstanley, managers can at the most identify only the two performance extremes in any employee group—the most outstanding and the worst—with the remainder falling into a middle category of "competent."

Winstanley criticizes the performance appraisal process, which functions as the basis for determining the amount of salary increase. He sees a number of nonperformance factors influencing appraisal results. These nonperformance factors include:

Purpose: Most performance-appraisal systems are multipurpose, with significantly different aims included. For example, ratings for salary-increase purposes as against ratings for assessing employee-development needs.

Current salary: Those with salaries above the midpoint of the range tend to receive higher ratings than those below midpoint, even though the contribution of experience to performance decreases sharply after time on the same job.

Feedback: When appraisals must be discussed with subordinates, the ratings are higher than when supervisor-subordinate discussion is not required.

Hierarchical status: Managers and top executives are rated higher than nonmanagement exempt employees. The argument advanced for this is that only the best performers get promoted. However, the counter-argument is that this assumes an excellent (not merely good or adequate) selection process. It also ignores the fact that higher-level positions are much more difficult to perform satisfactorily and should produce the same distribution of ratings as do lower-level positions.

Function: There are significant differences in ratings among functions in many companies. For example, the financial function may rate itself higher than does the manufacturing function.

Sex and race: Both research and the courts have found rating differences between sexes and among races not justifiable by valid performance differences.

Length of service: Performance tends to be rated higher as length of service increases.

Personal characteristics: The personalities of the rater and ratee, and/or the interaction between the two, can have a significant effect on the appraisal results.

Edward E. Lawler, Professor of Organizational Behavior and Director of the Center for Effective Organizations at the University of Southern California, believes that while nearly all companies claim to use merit pay systems, most of these have failed because employees are unable to see a direct relationship between their performance and their pay.[4] According to Lawler, this perceived lack of connection arises from (1) inadequate measures of performance; (2) poor communications where pay practices are either kept secret or communicated improperly; (3) poor pay-delivery systems where the procedures are so complex that the relationship between pay and performance is obscured; and (4) poor managerial behavior, often manifested in the failure to recommend

[2]Douglas McGregor, *The Human Side of Enterprise*. New York: McGraw-Hill Book Company, 1960.

[3]Nathan B. Winstanley, "How Accurate Are Performance Appraisals?" *Personnel Administrator*, August, 1980.

[4]Edward E. Lawler, "Merit Pay: Fact or Fiction? *Management Review*, April, 1981.

significantly different amounts of pay where large performance differences in fact exist among subordinates.

However, Lawler does see a few bright spots on the pay-for-performance horizon. For instance, employees continue to believe that people should be paid for performance—whether or not they believe it is actually being done. Also, the increasing sophistication of management information systems could be a positive force in relating pay to performance. Further, the trend toward decentralization has resulted in the creation of smaller business units, which makes it easier to relate individual performance to pay. Finally, there is a movement among companies to become more open and participative about their pay systems.

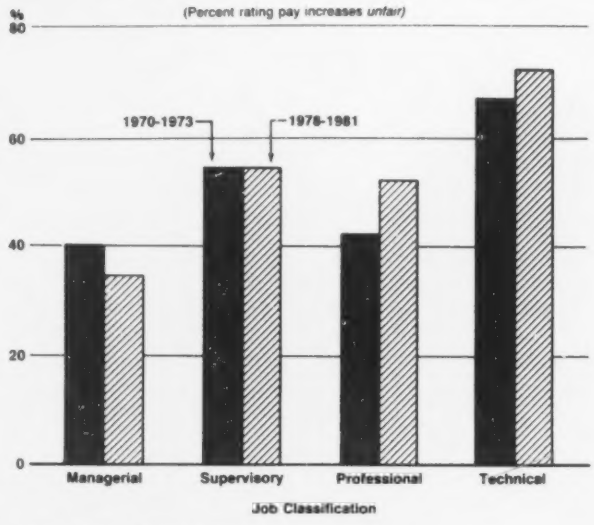
Employee Perceptions and Attitudes

Research has confirmed the impression of many that employees attach considerable importance to their pay. The Opinion Research Corporation tracked this over 20 years and found that, of 14 different job factors, pay was rated most important by employees. This held true for all job categories, both sexes, and all age groups except the under-30 group.[5]

Given the significance employees attach to their pay, what is their attitude toward pay for performance? Opinion Research has drawn information relative to this from its data bank of over 250,000 responses, covering different levels of employees in various types of industries. These findings indicate that, over time, the majority of employees surveyed about their perception of a link between performance and pay increases saw little connection between *effort* and subsequent pay raises. Among managers, supervisors and sales representatives, over 50 percent said

Exhibit 1:

Fairness Ratings of Pay Increases by Job Classification



Source: Opinion Research Corporation

effort and excellent performance would result in pay increases. However, this view was held by only one-third of professional and clerical employees and only one-quarter of hourly employees. Further, over time, the majority of employees surveyed said compensation systems were unfair in awarding increases and also in establishing pay differentials among jobs. This opinion was held by over 70 percent of technical employees, over 50 percent of supervisory and professional employees, and even by one-third of managerial employees, as shown in Exhibit 1.

The Two Parts of the Pay-for-Performance System

Pay for performance results from the interaction of two separate systems: the compensation and the performance-appraisal programs. In each case, pay for performance is one goal of the system, but not its sole objective.

With respect to the corporate-compensation program, in addition to paying for performance, one other purpose is to reflect the rates paid for similar positions in the labor market in order to be competitive with companies of like size, industry and/or geographical location. Another aim is to establish proper horizontal and vertical relationships among jobs within the organization, with positions of similar scope and responsibility receiving similar pay. A third objective is to provide a fair, logical and consistent salary-administration process by which the relationships among positions are maintained and employees have equal opportunities for salary advancement. A final purpose is to reflect both the financial results of the corporation in the past fiscal year and the prospects for the forthcoming period in the size of the funds budgeted for salary increases.

The performance-appraisal process, usually within the same plan, also has multiple objectives, one of which is pay for performance. (The possibility of conflicting objectives in the same plan, as raised by Nathan Winstanley, will be discussed below.) Other than determining pay increases, objectives served by performance-appraisal systems often include:

- Determining training and development needs;
- Planning in specific job performance goals;
- Identifying employees with promotion potential;
- Providing a basis for discussions of their performance

[5]William Schiemann, *Managing Human Resources, 1983 and Beyond,* Princeton, N.J.: Opinion Research Corporation, 1983.

Table 6: Salary Structure Practices, by Industry Category

Industry Category	Companies with Formal Salary Structures			Companies with Separate Exempt and Nonexempt Salary Structures		
		Number	Percent		Number	Percent
Manufacturing	(N = 302)	289	96%	(N = 289)	239	82%
Banking	(N = 145)	141	97	(N = 141)	95	67
Insurance	(N = 95)	90	95	(N = 90)	58	64
Diversified finance	(N = 15)	14	93	(N = 14)	9	64
Total	(N = 557)	534	96%	(N = 534)	401	75%

In their interaction in pay for performance, both systems serve the same end. Generally, the employee's performance is evaluated by the supervisor using the performance-appraisal system. Individual performance is then related to the performance of the others in the particular unit of the organization. The manager making the appraisals recommends salary increases for the employees in the unit, based on their performance and subject to the budgetary limits established for increases. Usually some "nonperformance" factors are also considered, such as position in the salary range and time since the last review.

Corporate Compensation Systems

The central part of the corporate compensation system is the salary structure: the formal relationship among jobs in terms of their relative value within the organization and their dollar value on the outside labor market. These relationships are established by job evaluation. The result is that jobs of similar internal and external worth are grouped in the same category or "grade" in the structure, with jobs of greater and lesser worth grouped in grades above and below. Each grade has a dollar minimum, maximum and midpoint. The minimum is the entry-level pay rate; the maximum is the most that can be paid to the incumbents; and the midpoint reflects the "market value" or average rate for the jobs in the grade. If there is a discrepancy between the internal worth of a job in relation to others and the external rate of pay, competitive-pay considerations usually take priority. This occurred recently when the market rates for certain electronic data-processing positions forced some companies to pay more than was justified on the basis of internal relationships.

The establishment and maintenance of the salary structure provide a path whereby individual employees have the opportunity to progress through their salary ranges and move by promotion into jobs with higher ranges. This is customarily done by creating sufficient spread between the minimums and maximums of the ranges to allow employees to receive periodic pay increases. Frequently, the higher the level of the job, the wider the salary range, since the higher salaries produce correspondingly larger increases and promotional opportunities are less frequent. In this process, various nonperformance constraints on individual increases are operative, including position in the salary range in relation to the midpoint, length of time since the last increase and the limitation of the budget for salary increases.

Formal Salary Structures

Virtually all (96 percent) of the companies participating in the survey reported formal salary structures. The same pattern of responses shown in Table 6 was seen in the four industry categories.

Three-quarters of the companies with formal salary structures had separate structures for exempt and nonexempt positions. With respect to the four industry groups, manufacturing companies were most likely to have separate exempt and nonexempt structures.

When separate exempt and nonexempt structures were reported, the median number of grades in the exempt structure for all industry categories combined was 19. The median number was 23 in manufacturing; 15 in banks; and 17 each in insurance and diversified finance. When there was one structure for both exempt and nonexempt jobs, the median number of grades for all industries combined was 25. The median for manufacturers was 29; banking, 27; and insurance, 25. There were insufficient data for diversified finance to permit separate analysis.

It should be mentioned that some companies using the Hay system, one of the job-evaluation methods discussed below, do not have salary grades as such.[1] Rather, each job had its own salary range based on the number of evaluation or "Hay" points assigned to it. Sixty-six companies, somewhat less than half the number using the Hay system, reported this practice.

[1]The Hay Guide Chart-Profile Method of job evaluation was developed by Hay Associates, Philadelphia, Pennsylvania. It provides a method for analyzing job content in terms of three factors: "know-how" (the knowledge and skills needed for satisfactory job performance); "problem solving" (the amount of original thinking required by the job); and "accountability" (the scope of the job within the organization).

Table 7: Type of Job Evaluation System, by Industry Category

Industry Category	Hay System		Ranking—Market Pricing		Point Factor		More Than One System		Factor Comparison		Other	
	Number	Percent	Number	Percent	Number	Percent	Number	Percent	Number	Percent	Number	Percent
Manufacturing (N=269)	92	34%[a]	79	29%	48	18%	25	9%	14	5%	11	4%
Banking (N=127)	33	26[a]	39	31	34	27	8	6	7	6	6	5
Insurance (N=84)	35	42	12	14	11	13	15	18	5	6	6	7
Diversified finance (N=11)	2	—	5	46	4	36	—	—	—	—	—	—
Total (N=491)	162	33[a]	135	28%	97	20%	48	10%	26	5%	23	5%

[a]Percentages do not add to 100 because of rounding.

Job-Evaluation Systems

Job-evaluation systems can be broadly grouped as "analytic" and "nonanalytic." Analytic job evaluation establishes the value of a position by determining the proportionate weights for the various elements required for its successful performance. For example, the relative degree of "know-how," "problemsolving," and "accountability" required to perform a job are the elements (or factors) used in one analytic job-evaluation method, the Hay system. The other two analytic job-evaluation methods dealt with here are the point-factor and factor-comparison systems.

The nonanalytic methods evaluate the job as a whole, rather than its components. This evaluation is done in terms of the internal worth of the job relative to others in the organization; in terms of its dollar worth on the labor market; or, most commonly, as a combination of internal and external values. The three variations were surveyed under the general heading, "ranking or market pricing." The other major nonanalytic method, classification or grading, is used almost exclusively in government and is not dealt with here. The General Schedule (GS) classification system of the U.S. Civil Service Commission is probably the best-known example of this approach.

Of the 550 companies responding to the survey question on job evaluation, 491 (almost 90 percent) reported a formal job-evaluation plan. Overall, the Hay system (or a modification of it) was the most widely used, with one-third of the respondents reporting it. Ranking or market-pricing systems were second among the entire sample, accounting for 26 percent of the systems. Third were point-factor approaches, used by 20 percent of all respondents.

In terms of the four industry categories, the Hay system was most widely used among manufacturing and insurance companies. Banks and diversified financial companies, on the other hand, preferred ranking or market pricing. Table 7 shows the prevalence of the different evaluation systems by industry group and for the entire sample.

Pay Increases

The surveyed companies were asked about their *policies* governing the various types of pay increases that could be granted to exempt employees. They were also asked to report the size of increases *actually granted* to exempt employees in 1982. The types of salary increases surveyed were:

Merit: Individual, performance-based pay increases.

General: Uniform pay increases granted to all (or most) employees simultaneously.

COLA (Cost-of-living): Pay increases determined by a cost-of-living formula.

Of the 557 companies surveyed, 95 percent reported policies for granting merit increases to exempt employees. This percentage was identical for all industry categories, except the diversified financial group, where all the companies reported merit-increase policies for exempt personnel.

In contrast with the prevalence of policies for merit increases, general and COLA increase policies were relatively infrequent for exempt employees. They were reported by only 19 percent and 14 percent of all companies, respectively. These increases are most common for hourly employees, particularly those represented by collective-bargaining agreements.[2] Table 8 (page 12) shows the frequency of use of policies for granting the three types of increases to exempt employees for each industry category.

With respect to increases actually granted, 510 companies (96 percent of the 531 with merit-increase policies) granted these increases to at least some of their exempt employees during 1982. In terms of the industry groups, all of the banks and diversified financial companies granted merit increases, as did 98 percent of the insurance companies and 93 percent of the manufacturers.

The median merit increase for all industries combined was 8.8 percent of salary. This did not vary appreciably among the industry categories, ranging from 8.7 percent (manufacturing and banks) to 9 percent (insurance and diversified finance).

Overall, general and COLA increases granted to exempt employees were a very small part of 1982 compensation actions. Only 14 companies granted general increases; and

[2]Peck, Report No. 796, 1981.

Table 8: Salary-Increase Policies Covering Exempt Employees, by Industry Category

Industry Category	Type of Policy: Merit Number	Merit Percent	General Number	General Percent	COLA Number	COLA Percent
Manufacturing (N = 302)	288	95%	60	20%	44	15%
Banking (N = 145)	138	95	23	16	18	12
Insurance (N = 95)	90	95	22	23	13	14
Diversified finance (N = 15)	15	100	2	13	2	13
Total (N = 557)	531	95%	107	19%	77	14%

only 15 made any COLA adjustments. The 1982 median general increase for all companies granting them was 6 percent, and the overall median COLA increase was 3.2 percent. The numbers in each industry category granting these increases were too small for analysis.

With respect to exempt employees, Table 9 shows the prevalence of the various types of increases *granted* during 1982 in each industry category and for the whole sample; Table 10 shows the amount of each type of increase granted in 1982 for all companies combined; Table 11 summarizes the range in size of *merit increases only* for the four industry categories and for all industries combined. Thus, in regard to both compensation *policies* and *practices,* in the particular year 1982, the merit increase is practically the sole method for raising the pay of exempt personnel. This is the result of a philosophy (pay for performance) manifested in a technique (merit pay).

It is important to recognize, however, that while merit increases are related to employee performance, they do not reflect performance exclusively. If this were the case, salary increases would always be granted when there was identifiable performance improvement. As discussed previously, most companies have established through job evaluation a maximum dollar value for positions that, generally, cannot be exceeded—regardless of performance improvement.

Conversely, if performance were the sole basis for pay increases, when the quality of an employee's work declined his (or her) salary would be reduced. In actual practice this occurs very rarely; discharge usually comes before a pay cut. In fact, it has been held that merit-pay plans, at best, represent only a partial pay for performance because there is no real downside risk.

A number of nonperformance factors, previously referred to, are taken into consideration in determining the size and frequency of merit increases for exempt employees. Merit-pay plans are thus a compromise between pay for individual performance and the nonperformance factors, which may include:

- Position in the salary range;
- Time since last increase;
- Size of last increase;
- Pay relationships within the unit;
- Pay relationships with similar jobs in other units;
- Pay of similar jobs in other companies;
- Pay levels of newly hired employees;
- Supervisor-subordinate pay relationships;
- Budgetary limits on salary increases.

Some companies have explicitly stated that the merit increase is the "vehicle" for raising exempt pay, recognizing the influence of factors other than, or in addition to, individual performance.

Merit-Pay Administration

The administration of the typical merit-pay program for exempt employees involves establishing a merit-increase budget; the allocation of it among units in the company; and the issuance of guidelines to managers to aid them in determining individual merit increases for the employees they supervise.

Table 9: Types of Increases Granted in 1982 to Exempt Employees, by Industry Category

Industry Category	Types of Increase: Merit Number with Policy	Merit Number of Increases	Merit Percent	General Number with Policy	General Number of Increases	General Percent	COLA Number with Policy	COLA Number of Increases	COLA Percent
Manufacturing	288	269	93%	60	8	13%	44	10	23%
Banking	138	138	100	23	1	4	18	2	11
Insurance	90	88	98	22	5	23	13	3	23
Diversified finance	15	15	100	2	—	—	2	—	—
Total	531	510	96%	107	14	13%	77	15	19%

Table 10: Size of 1982 Increases for Exempt Employees, All Industries (as percents of salary at time of increase)

Type of Increase	Number of Companies	Size of Increase		
		Median	Middle 50 Percent Range	
			Low	High
Merit	510	8.8%	7.5%	9.8%
General	14	6.0	4.5	7.0
COLA	15	3.2	1.6	5.1

Merit-Increase Budgets

A budget for the year's merit increases is usually established in the late Summer to early Fall of the preceding year. A number of considerations determine the amount to be spent for merit increases. Table 12 shows the number of times each of several major considerations influencing the budget was mentioned, and the average rank of importance each was given by the respondents. Industry group data are not shown since there was almost no variation from the composite results.

Allocation of Merit-Increase Budgets

When the merit-increase budget is allocated among units of the corporation, the method most frequently used (63 percent of the respondents) is to distribute a uniform percent of payroll to all units. Thirteen percent allocated the budget according to the compa-ratio of the unit. (Compa-ratio is the relationship between the average salary in a unit and the unit's average salary-grade midpoint.) Twenty-two percent used some other method, most often allowing each unit to devise its own budget. The remaining companies used more than one method of allocation. Table 13 shows the occurrence of these practices among the four industry groups and overall.

Merit-Pay Guidelines

It was the practice of 456 (83 percent) of the 552 companies answering the question to issue guidelines to managers as an aid in recommending merit increases for their subordinates. These guidelines usually related ranges of merit-increase possibilities, expressed as percents of salary, to performance categories ranging from unsatisfactory (however defined) to outstanding (however defined).

The simpler guidelines have only two variables: level of performance as the independent variable and the range of merit-increase possibilities as the dependent variable. Exhibit 2 (on page 14) is an example of this type of guideline. The more complex guidelines have other variables in addition to performance level and merit-increase amounts—usually position in the salary range and time since last in-

Table 11: 1982 Merit Increases to Exempt Employees, by Industry Category (as percents of salary at time of increase)

Industry Category	Number of Companies	1982 Merit Increase		
		Median	Middle 50 Percent Range	
			Low	High
Manufacturing	269	8.7%	7.2%	9.8%
Banking	138	8.7	7.9	10.0
Insurance	88	9.0	8.0	9.9
Diversified finance	15	9.0	8.0	9.7
Total	510	8.8%	7.5%	9.8%

Table 12: Considerations in Establishing Merit-Increase Budgets, All Industries

Factor	Number of Mentions	Average Rank[1]
External pay relationships	503	1.9
Company financial results	471	2.6
Company financial prospects	452	2.9
Internal pay relationships	419	3.7
Cost-of-living changes	420	4.3
Ability to hire	386	4.7

[1] = most important.

Table 13: Allocation of Merit-Increase Budgets Among Units, by Industry Category

Industry Category	Allocation Practice							
	Uniform Percent of Payroll		Unit Compa-ratio		Other		More Than One Method	
	Number	Percent	Number	Percent	Number	Percent	Number	Percent
Manufacturing (N = 291)	176	61%	36	12%	70	24%	9	3%
Banking (N = 136)	102	75	15	11	18	13	1	1
Insurance (N = 88)	50	57[a]	18	21	20	23	—	—
Diversified finance (N = 15)	8	53	1	7	6	40	—	—
Total (N = 530)	336	63%	70	13%	114	22%	10	2%

[a]Percentages do not add to 100 because of rounding.

Exhibit 2: Two-Variable Merit-Increase Guideline: A Paper Products Company

Definition of Performance Characteristics	*Percentage of Base Salary*
Exceptional personal contribution to departmental, divisional or corporate goals. Performance attainments are clearly obvious to all. Results attained far exceed position requirements.	9
Accomplishments surpass those attained by the majority of others similarly classified, and usually exceed position requirements and normal expectations. Demonstrated potential as candidate for higher classification.	6.0-8.0
Work meets position requirements either fully or with rare exceptions, and represents the level of performance expected.	3.5-6.0
Results are frequently less than desired, and necessity for further development is clearly recognizable.	2.0-3.5
Performance falls seriously below minimum requirements. Adaptation to position requirements or company standards highly questionable.	0

crease. Exhibit 3 illustrates the more complex type of guideline.

Latitude for the manager's judgment in recommending merit-increase amounts and timing was built into most of the guidelines studied. The manager determined the performance level of the employee and then recommended the merit increase, working within the allowable range of increase amounts and the restrictions imposed by time since last increase and position in the salary range. Overriding these variables was the limitation imposed by the amount allocated to the particular unit for salary increases. Some companies did not make the unit's total salary budget an absolute limit, however, for managers could be granted extra merit dollars if they could justify the need on an "exceptional case" basis. Whether or not the budget acted as an absolute limit, many companies treated guidelines literally as "guides," and allowed managers to depart from them in the event of special circumstances—usually some sort of pay inequity. Following are some situations where departures from merit-increase guidelines were allowed:

- Adjustment for external equity;
- New hire at higher rate than a current employee in the same position;
- Supervisor-subordinate pay compression;
- Need to retain an employee;
- Need to comply with legal equal-pay requirements;
- Need to correct a below-salary-range-minimum situation.

Range of Actual Merit Increases

The range of merit increases actually granted in a year can provide a clue to the rigor with which pay for performance is being pursued by the companies surveyed. The greater the spread between the lowest merit increase granted and the highest, the greater, presumably, is the discrimination being made on the basis of performance. The complaint frequently heard from survey participants was that managers responsible for recommending merit increases did not use the full range of increase possibilities or, expressed another way, overused the middle categories by giving all their subordinates increases within a narrow band. (This problem is discussed further on pages 21-22.)

The companies surveyed were asked to report the actual "low" and "high" merit increases granted to their exempt populations in 1982. The median *low* merit increase for the entire sample was 5 percent of salary; the median *high* merit increase was 14.3 percent. The median low and high merit increases for each industry group appear in Table 14.

Overall, the spread between the low and high increase was 9.3 percentage points. The median high merit increase was almost three times as much as the median low increase, a most definite distinction. However, it must always be kept in mind that the nonperformance factors listed earlier influence the merit-increase awards.

When the industry categories in Table 15 are examined, the spread between the low and high increases ranged from 9 percentage points (manufacturing and insurance) to 11 percentage points (banking). The high median increase of 15 percent in the banking industry was almost four times the low increase of 4 percent.

Table 14: 1982 Low and High Merit Increases, by Industry Category (as percents of salary at time of increase)

	Low Merit Increase		*High Merit Increase*	
Industry Category	*Number of Companies*	*Median*	*Number of Companies*	*Median*
Manufacturing	211	5.0%	259	14.0%
Banking	98	4.0	134	15.0
Insurance	56	5.0	82	14.0
Diversified finance	9	5.0	14	15.5
Total	374	5.0%	489	14.3%

Exhibit 3: Multivariable Merit-Increase Guideline: An Insurance Company

	Position in Range in Relation to Midpoint				
Performance	*Below 0.90 (Below Minimum)*	*0.81-0.95*	*0.96-1.05*	*1.06-1.20*	*Above 1.20 (Above Maximum)*
Well exceeds accountabilities	12%-15% 9 months[a]	12%-15% 12 months	12%-15% 12 months	11%-14% 15 months	7% * 18 months
Exceeds accountabilities	9%-11% 9 months	9%-11% 12 months	9%-11% 12 months	8%-10% 15 months	6% * 18 months
Meets accountabilities	6%-8% 9 months	6%-8% 12 months	6%-8% 12 months	5%-7% 15 months	5% * 18 months
Meets most accountabilities	5% 9 months	5% 12 months	5% 15 months	5% 18 months	No increase
Meets few accountabilities	No increase	No increase	No increase	No increase	No increase

*Requires special approval

[a]In all cases, months since last increase.

When the high and low merit increases from Table 14 are compared with the median merit increases for the entire sample and for each industry group from Table 11, a somewhat different perspective emerges. The 1982 overall merit increase was 8.8 percent. The 1982 low merit increase was 5 percent and the high increase was 14.3 percent. Thus, the difference between the low and overall increases was 3.8 percentage points, while the difference between the overall and high increases was 5.5 percentage points. This suggests less pay distinction between average and low increases than between average and high increases. This same pattern holds true among the four industry groups, as shown in Table 15.

The tentative conclusion from these comparisions is that more pay increase distinction is made between superior and average performance than between average and inferior performance. This may illustrate the tendency (mentioned earlier) to avoid the downside risk involved in giving substantially lower or even "zero" increases to below-average performers.

Other Pay for Performance

In addition to the merit increase, which recognizes employee performance to at least some degree, there are a number of other arrangements that pay compensation to exempt employees on some kind of performance basis. The performance in question may be that of an individual, of a team of employees, of a corporate unit such as a department or division, of the whole corporation, or any combination of these.

The programs themselves may be quite formal, with the amount of compensation mathematically determined according to the degree of achievement of preset goals; or they may be highly discretionary, with the size of awards depending on subjective evaluation of performance. Many plans provide for a split award—with a portion determined by some sort of formula and the remainder depending on individual performance evaluation. Table 16 shows the prevalence for each industry category and for the entire sample of the most frequently used nonsalary compensa-

Table 15: Comparison of 1982 Merit-Increase Medians, by Industry Category
(as percents of salary at time of increase)

	Low Merit Increase vs. Median Merit Increase			*High Merit Increase vs. Median Merit Increase*		
Industry Category	*Median Low Merit Increase*	*Median Merit Increase*	*Difference*	*Median High Merit Increase*	*Median Merit Increase*	*Difference*
Manufacturing	5.0%	8.7%	3.7	14.0%	8.7%	5.3
Banking	4.0	8.7	4.7	15.0	8.7	6.3
Insurance	5.0	9.0	4.0	14.0	9.0	5.0
Diversified finance	5.0	9.0	4.0	15.5	9.0	6.5
Total	5.0%	8.8%	3.8	14.3%	8.8%	5.5

Table 16: Nonsalary Compensation Plans Including Exempt Employees, by Industry Category

	Industry Category									
	Manufacturing (N = 302)		Banking (N = 145)		Insurance (N = 95)		Diversified Finance (N = 15)		Total (N = 557)	
Type of Plan	Number	Percent of Companies	Number	Percent of Companies	Number	Percent of Companies	Number	Percent of Companies	Number	Percent of Companies
Top executive bonus	219	73%	68	47%	32	34%	3	20%	322	58%
Long-term incentive	91	30	7	5	3	3	—	—	101	18
All employee bonus	28	9	8	6	5	5	4	27	45	8
Current profit sharing	24	8	28	19	7	7	2	13	61	11
Group productivity incentive	7	2	6	4	3	3	1	7	17	3
Group cost control incentive	2	1	—	—	—	—	1	7	3	—

tion programs which include at least some exempt employees.[3]

The performance-related compensation program most frequently found among the sample was the annual top-executive bonus plan. This type of incentive plan provides for the possibility of awards to eligible employees from a fund determined by a formula based on annual corporate profits. Bonus eligibility is generally determined by job title, organization level, salary grade, or minimum salary. The amounts awarded from the bonus "pool" to individual recipients is based on an evaluation of their performance in the year, quite often in respect to achievement of specific goals and objectives set at the beginning of the bonus period.[4] These plans may contain "lightning strike" provisions, where a contribution (such as an invention or the development of a cost-savings method) by an employee not ordinarily eligible for a bonus can result in a special award.

Top-executive bonus plans were found most often among manufacturers, where 219 of 302 manufacturing companies reported them. Although the number of banks, insurance companies and diversified financial institutions with these plans has steadily increased over the years, still less than half reported such arrangements.

Long-term management incentive plans, also called performance unit/share plans, were second, but a very poor second, to top-executive bonus plans in frequency. These plans were found almost exclusively among manufacturers; 91 of the 101 plans were in manufacturing companies.

Awards under these plans depend on the achievement of certain corporate results over three, four or five years. The goal most often used is the attainment of a targeted increase in earnings per share. At the start of the performance period, units representing either dollar amounts (performance units) or shares of stock (performance shares) are contingently credited to a participant's account. If the target is met by the end of the performance period, the participant receives the full number of dollars or shares of stock in his (or her) account. If the target is exceeded, a greater amount is paid up to a specified maximum. If the target is missed, the actual award will be less than the contingent amount, down to a specified minimum below which no award is paid.[5]

The top-management bonus program and the long-term management-incentive plan are, as the names imply, designed primarily for upper management. Although there is some participation by exempt employees below that level, it is not extensive—particularly in the case of the long-term plans which are, in fact, used almost exclusively for top executives. The other types of programs surveyed, including all-employee bonus plans, current pay profit sharing, group productivity, and group cost-control incentives, had a very low incidence of use among exempt employees. There was no indication of performance-based pay plans designed specifically for the exempt population as a whole.

Table 17 shows the amount of compensation, as a percent of 1982 salary, paid to four levels of exempt employees from *all* performance-related compensation programs combined, excluding the salary program. The information is shown for the total sample and for each industry category except diversified finance, where the number of payments was too small for analysis.

Compensation practitioners generally believe that for incentive compensation to be an effective motivator, it should be at least 10 percent of the recipient's salary. The overall median payment from all incentive plans for the top-executive group was 30 percent of base salary. Median payments ranged from a high of 38 percent among manufacturing companies to a low of 15 percent among insurance companies. Therefore, in all cases, total incen-

[3]Stock-option plans have been excluded because of the difficulty in establishing a dollar value of awards for comparison with other awards. For information on these plans, see Fox, Research Bulletin No. 148, 1983.

[4]See Fox, Report No. 760, 1979.

[5]For an analysis of these plans, see Lawrence C. Bickford, "Long-term Incentives for Management, Part 6: Performance Attainment Plans." *Compensation Review*, Third Quarter, 1981, and Fox, Research Bulletin No. 132, 1983.

Table 17: 1982 Total Awards to Exempt Employees from Nonsalary Compensation Plans, by Industry Category
(as percent of salary at time of award)

	Manufacturing			Banking			Insurance			Total		
		Middle 50-Percent Range			Middle 50-Percent Range			Middle 50-Percent Range			Middle 50-Percent Range	
Level of Employee	Median	Low	High	Median	Low	High	Median	Low	High	Median	Low	High
Top executive	38%	24%	52%	20%	11%	30%	15%	10%	23%	30%	16%	47%
Middle management	20	12	27	13	9	18	10	5	13	18	10	25
Lower management	10	6	15	10	6	15	5	2	6	10	5	15
Other exempt	6	3	10	9	6	11	5	2	6	7	4	10

tive compensation for top executives was over the "effective threshold." The same is true for middle management where median overall incentive compensation was 18 percent of salary and the range was from 20 percent (manufacturers) to 10 percent (insurance). Lower management made the 10-percent threshold overall and in manufacturing and banking; insurance companies reported median total incentive compensation of 5 percent. Payments to nonmanagement exempt employees were below 10 percent in all cases, with an overall median of 7 percent.

In 1982, according to this analysis, performance-related compensation plans, other than the salary program, generally did not play a significant role in the compensation of exempt employees other than the top-management group, and to some extent, middle management.

Corporate Performance-Appraisal Systems

The other half of the pay-for-performance process, as already indicated, is the performance-appraisal system.[6] Just as there are nonperformance aspects to the compensation system, there are other uses for data generated by performance-appraisal systems than determining performance-related compensation. The information produced by the performance-appraisal process is also needed for overseeing current operations and planning for the future; for determining transfers, promotions, demotions and terminations; and for developing manpower plans and assessing future staffing requirements.

Prevalence of Formal Performance Appraisal

Formal performance-appraisal systems, used for determining merit increases for *any* exempt employees, were reported by 83 percent (459) of the 553 companies answering the question. As shown in Table 18, formal programs were most often found in banking and insurance.

Performance Areas Evaluated

The participating companies were asked to specify the items evaluated by their performance-appraisal systems in determining exempt merit increases. They were also asked to rank the relative importance of each. Table 19 shows the responses from the entire sample; since there was almost no variation from these results among the four industry groups, separate data are not shown. The "achievement of specified performance results" was mentioned most frequently and had the highest average rank.

Methods of Appraising Performance

Over the years, a number of different approaches to performance appraisal have been developed. All are current-

Table 18: Prevalence of Formal Performance-Appraisal Systems, by Industry Category

	Companies with Formal Peformance-Appraisal Systems	
	Number	Percent
Manufacturing (N = 299)	232	78%
Banking (N = 145)	134	92
Insurance (N = 94)	82	87
Diversified finance (N = 15)	11	73
Total (N = 553)	459	83%

Table 19: Items Evaluated by Performance-Appraisal Systems, All Industries

Item	Number of Mentions	Average Rank[1]
Achievement of specified performance results	429	1.1
Evidence of specified on-the-job behavior	366	2.5
Evidence of general management or professional skills	377	2.6
Evidence of promotion potential	322	3.9
Evidence of specified personal characteristics	289	4.3

[1] = most important.

[6] See Robert I. Lazer and Walter S. Wikstrom, *Appraising Managerial Performance: Current Practices and Future Directions*. The Conference Board, Report No. 723, 1977.

Table 20: Types of Performance-Appraisal Systems Used for Exempt Merit Increases, by Industry Category

	Industry Category									
	Manufacturing (N = 229)		Banking (N = 134)		Insurance (N = 81)		Diversified Finance (N = 11)		Total (N = 455)	
Type of System	Number	Percent	Number	Percent	Number	Percent	Number	Percent	Number	Percent
Management by objectives (MBO)	114	50%[a]	53	40%	39	48%	6	55%	212	47%[a]
Essay or open-ended questions (as the only method)	32	14	26	19	11	14	2	18	71	16
Ratings										
Graphic rating scale	19	8	19	14	10	12	—	—	48	11
Behaviorally anchored rating scale	1	—	—	—	1	1	—	—	2	—
Checklists										
Straight checklist	13	6	5	4	6	7	—	—	24	5
Forced choice	10	4	9	7	7	9	1	9	27	6
Ranking or comparison										
Straight ranking	5	2	5	4	2	3	—	—	12	3
Alternation ranking	2	1	1	1	—	—	—	—	3	1
Paired comparison	—	—	2	2	—	—	—	—	2	—
Other or combination	33	14	14	10	5	6	2	18	54	12

[a]Percentages do not add to 100 because of rounding.

ly in use to at least some extent. The various methods can be classified according to the following categories:

- Rating scales;
- Checklists;
- Rankings or comparisons of employees with one another;
- The comparison of results with preset objectives;
- Open-ended narrative descriptions of performance.

In actual use, these distinctions among performance-appraisal approaches are not always clear-cut, and the same system may employ more than one method. Table 20 shows the various performance-appraisal approaches used in each of the four industry groups and for all industries combined.

The performance-appraisal method most freqeuntly used was management-by-objectives (MBO). Forty-seven percent of the 455 companies identifying their system used it—almost three times as many as used any other approach. Management-by-objectives was also most frequently used in each of the four industry categories.

The next most often used performance-appraisal system was the essay, or open-ended question, method as *the only method used*. However, it ran a rather poor second to MBO systems.

The actual use of the essay, or open-ended question, approach was no doubt somewhat greater than these data indicate, for it is often used in conjunction with other methods. For example, management-by-objectives appraisal systems also use essays, and very often require open-ended or narrative statements concerning planned results. Furthermore, most appraisal forms, regardless of type, ask for a narrative statement by the manager of each subordinate's overall strengths and weaknesses.

Relative Appraisal

For the purpose of determining merit increases, it is customary to convert the results of the appraisals of individual employees to a distribution of overall performance evaluation, each employee relative to the others in the group being appraised. The three main methods used to accomplish this conversion are: (1) the distribution of employees results automatically from a ranking or paired-comparison approach; (2) the values on a rating scale are totaled (or given other formula treatment) to arrive at overall numerical ratings which are then distributed; and (3) the appraiser makes a judgmental overall rating of each employee's performance after completing the other parts of the appraisal, with the individual judgments then being distributed.

A judgmental approach was by far the most commonly used method. It was reported by 85 percent (362) of the 424 companies answering the question. Formula treatment was used by 12 percent (48), while automatic distribution accounted for only 3 percent (14) of the sample.

Performance Categories

The distribution of appraisal results for merit-increase purposes is usually done by assigning them to performance categories. These are the categories that appear on the merit-increase guidelines and are related to ranges of possible increases. (See pages 13-14 above.) The performance categories may be identified by a word, for example, "distinguished," "commendable," "competent" or "unsatisfactory"; by number, from best to worst or worst to best; or by a letter designation. At any rate, each category

Exhibit 4: Five Performance Categories, Modified Numerical Code: A Life Insurance Company

1 ☐	2 ☐	3 ☐	4 ☐	5 ☐
PROVISIONAL	**ADEQUATE**	**COMPETENT**	**COMMENDABLE**	**DISTINGUISHED**
A provisional rating for inexperienced newcomers and others whose performance is clearly below the acceptability level. Incumbents should either move up in performance or be removed from the position in a relatively short time.	Rating for employees whose performance comes close to being "acceptable," but the need for further development is recognizable.	Rating for employees whose performance is fully "capable or worthy of being accepted; satisfactory; sufficient."	Rating for employees whose performance is clearly better than "acceptable" or "expected."	This rating is normally reserved for those few individuals whose outstanding performance is obvious to all.

Exhibit 5: Four Performance Categories, Straight Numerical Code: A Consumer Products Company

Performance Code	*Definition*
1	Unique and exceptional performance achieved by very few employees.
2	Performance that consistently meets and may exceed job requirements. It is expected that most employees would be rated in this category.
3	Performance where improvements are needed to meet job requirements.
4	Performance which is unacceptable.

Exhibit 6: Four Performance Categories, Letter Code: A Building Products Company

A. Exceptional—Consistently exceeds goals, objectives and standards of performance
B. Commendable—Consistently meets and frequently exceeds goals, objectives and standards
C. Competent—Meets overall goals, objectives and standards of performance with weaknesses offset by strengths
D. Unsatisfactory—Fails to meet minimum goals, objectives and standards of performance, and requires improvement to reach competent level

has a description attached to it for use of the manager making the appraisal. Exhibits 4, 5 and 6 illustrate different examples of performance-appraisal categories used by the survey participants.

Ninety-two percent (422) of the 458 companies answering this question assigned the appraisal results to performance categories. The median number of categories used was five; there was no variation from these practices when the data were examined according to type of industry.

Forced Distribution

A problem in the application of the compensation-performance-appraisal system to pay for performance is "the tail wagging the dog." This results when a manager decides in advance what salary increase to give a subordinate, and then manipulates the performance appraisal so the results will justify the desired increase. The employee in question is then slotted in the performance category that, under the guidelines, yields the predetermined increase. Another problem, which has been mentioned previously, is the tendency of some managers to overuse the middle performance categories and neglect the full scale of increase possibilities, particularly the lower end of the scale.

To counter these tendencies, some companies use a "forced distribution" approach when managers rate employees relative to each other for merit-increase determination. Forced distribution requires the appraiser to assign specific percentages of subordinates to each performance category: for example, 10 percent in the top category, 20 percent rated better than average, 40 percent average, 20 percent below average, and 10 percent unsatisfactory. The outcome of this forcing is the bell-shaped curve of normal statistical distribution. Although this method would seem to eliminate overuse of middle categories and guard against undue severity or leniency and manipulation, many managers find its rigidity a curb on, and a criticism of, their ability to make proper judgments. This approach also tends to break down and become meaningless when small numbers of employees are involved.

Formal forced distribution requirements were found in 10 percent (46) of the 454 companies answering the question. Thirty-seven percent (166 companies) said that although they did not formally require forced distribution, they did try to get managers to reflect a normal (bell-shaped curve) distribution of their performance ratings. Practices in regard to forced distribution by industry group are shown in Table 21.

Purposes of Performance-Appraisal Systems

Most of the performance-appraisal systems for exempt personnel studied here were multipurpose. That is, the data

Table 21: Forced Distribution Practices, by Industry Category

Industry Category	Forced Distribution Practice					
	Formally Done		Informally Done		Not Done	
	Number	Percent	Number	Percent	Number	Percent
Manufacturing (N = 228)	29	13%	82	36%	117	51%
Banking (N = 133)	9	7[a]	50	38	74	56
Insurance (N = 82)	7	9	32	39	43	52
Diversified finance (N = 11)	1	9[a]	2	18	8	72
Total (N = 454)	46	10%	166	37%	242	53%

[a]Percentages do not add to 100 because of rounding.

Table 22: Purposes Served by Performance-Appraisal Systems, by Industry Category[1]

Purpose	Industry Category				
	Number of Manufacturers (N = 232)	Number of Banks (N = 134)	Number of Insurance Companies (N = 82)	Number of Diversified Financial Companies (N = 11)	Total (N = 459)
Determining merit increases	232	134	82	11	159
Providing basis for giving employees feedback on their performance	222	131	79	10	442
Planning job-performance goals with employees	198	120	72	11	401
Determining training and development needs	178	103	62	9	352
Identifying promotion potential	175	100	61	10	346
Identifying employees with specific skills and abilities	115	68	48	5	236

[1]A company may indicate as many purposes as applicable.

generated by the appraisal process were used for a number of different ends. A question was asked to determine what major purposes these data were used for—in addition to determining merit increases. Table 22 summarizes the responses.

Other than determining merit increases, the purpose for which performance appraisal data were most often used by all industries, except diversified finance, was to provide a basis for giving employees feedback on their performance.

From among the different purposes served by the same appraisal plan, the participants were asked to specify the one they considered *most* important and the one they considered *second most* important. Table 23 shows the frequency with which the various purposes were rated most important by the respondents; Table 24 shows the information for the second most important purpose.

The most important purpose served by the performance-appraisal system, according to the participants, was determining merit increases. This was true in all four industry categories. The second most important purpose for the sample as a whole was providing performance feedback to employees.

An immediate reaction to the high priority given to merit-increase determination might well be to consider it a result of the fact that the great majority of respondents were compensation administrators, who would naturally regard their own function as most important; and this may be true to an extent. However, when the designations by the whole sample of merit-increase determination as most important and employee feedback as second most important are considered together, it appears there may be more involved than the very natural tendency to see one's own function as having highest priority. When a performance-appraisal program for exempt employees is regarded as a total system for employee, and especially management, development, the two items can be seen as having greater real importance than is at first apparent. Administering a compensation program to motivate and reward superior performance and providing information to employees on how they are currently performing their jobs are vital underpinnings for the entire development process.

The fact that most survey participants designate merit-increase determination as the most important purpose and employee feedback as the second most important highlights the potential for conflicting objectives in multipurpose appraisal systems. Deciding merit-increase awards is an administrative decision. The appraiser's function is to judge on the basis of the employee's past performance. On the other hand, when the appraiser is giving the employee feed-

Table 23: Most Important Purpose Served by Performance-Appraisal Systems, by Industry Category

Most Important Purpose	Industry Category: Number of Manufacturers (N = 225)	Number of Banks (N = 131)	Number of Insurance Companies (N = 82)	Number of Diversified Financial Companies (N = 11)	Total (N = 449)
Determining merit increases	90	65	39	5	199
Providing basis for giving employees feedback on their performance	85	49	29	2	165
Planning job-performance goals with employees	42	15	11	3	71
Identifying promotion potential	5	1	1	1	8
Determining training and development needs	3	1	1	—	5
Identifying employees with specific skills and abilities	—	—	1	—	1

Table 24: Second Most Important Purpose Served by Performance-Appraisal Systems, by Industry Category

Second Most Important Purpose	Industry Category: Number of Manufacturers (N = 220)	Number of Banks (N = 128)	Number of Insurance Companies (N = 80)	Number of Diversified Financial Companies (N = 11)	Total (N = 439)
Determining merit increases	69	36	22	2	129
Providing basis for giving employees feedback on their performance	66	43	38	2	149
Planning job-performance goals with employees	46	34	13	5	98
Determining training and development needs	25	7	4	—	36
Identifying promotion potential	12	7	2	1	22
Identifying employees with specific skills and abilities	2	1	1	1	5

back on past performance, presumably for the purpose of encouraging future performance improvements, the appraiser functions best in the role of a counselor.[7]

[7]For a discussion of this problem, see H.H. Meyer, E. Kay and J.R.P. French, Jr., "Split Roles in Performance Appraisal," *Harvard Business Review*, January-February, 1965.

Apparently the problem of conflicting purposes has not caused many of the companies surveyed to use more than one performance-appraisal system for the same group of exempt employees. In answer to a specific question, only 10 percent of the respondents indicated that they use more than one system for the same exempt group.

Pay for Performance: Success and Failure Compared

This final section is chiefly concerned with comparing the pay-for-performance systems that survey respondents perceived as very successful with those which were viewed as failures to see if there are any clues as to what constitutes a "good" system. The more theoretical difficulties with pay for performance were discussed above (pages 7-9). It is important, however, also to note the more practical considerations.

Practical Problems in Paying for Performance

Survey respondents were asked to mention the major problems encountered in trying to pay for performance. Following is a list of the problems cited:

- Lack of consistency in ratings among different managers, units, divisions or departments;
- Too many high ratings;
- Too few low ratings;
- Failure of managers to distinguish satisfactorily among different performance levels resulting in an overuse of the middle categories;
- Too many requests by managers for exceptions to guidelines or policies;

- Overemphasis on internal, nonperformance factors such as longevity, personality, length of service in the company, time on the job, and mechanical considerations such as position in the salary range and time since last increase;
- Performance objectives not clearly defined;
- Dealing with employee perceptions and expectations;
- Failure of managers to use the system correctly.

According to the respondents, who were mostly compensation administrators, the majority of the practical problems encountered in trying to make pay for performance work were caused by the managers responsible for applying the system—and not by defects in the system itself. Underlying this criticism of managers seemed to be an awareness by the participants that no matter how good the system might be, it must be used correctly to accomplish its objective. The respondent for a computer company said: "The major problem involves management discipline and training. The compensation and performance-appraisal tools are good, they are just not used effectively."

Managers' lack of consistency was most frequently mentioned by the respondents. An electronics firm reported: "The weakest point in any performance-based program is the disparity among different managers' perceptions of good, bad and average performance. Inequities result when amounts of increases are based on these perceptions."

The second most frequently mentioned item was the failure of managers to distinguish adequately among performance levels, resulting in an overuse of the middle categories. A diversified manufacturing company's spokesperson said: "Managers find it difficult to make marked distinctions and, therefore, tend to give the average increase to all."

Although it would seem that these two problems might be alleviated, at least in part, by requiring a forced distribution, there was apparently a general reluctance to curtail the scope of managerial judgment. An oil company's respondent summed it up: "A major problem is trying to ensure consistency across different divisions, while at the same time not wanting to force appraisal ratings or inhibit managers from using their own discretion and judgment."

Table 25 shows the number of times each problem was mentioned by each industry group and by the entire sample.

Pay-for-Performance Failures

As shown in Table 4 (page 7), 83 out of 521 companies (16 percent) categorized their programs as failures. In about one-third of the reported failures, the two problems just discussed—lack of differentiation among performance categories and lack of consistency among raters—were severe enough to cause the pay-for-performance effort to fail. About one in seven of the companies with unsuccessful systems said the failure resulted from salary-increase budgets that were too small for meaningful rewards. About one-quarter gave a variety of "other" reasons for failure. The reasons for the remaining failures were spread among the practical problems shown in Table 25.

"Other" reasons given by particular companies for pay-for-performance failure were:

> "Compensation objectives are neither formally set by management nor communicated sufficiently to employees."
> —*An Insurance Company*

> "Crisis management often rules—for example, raises are influenced by outside threats to hire away."
> —*A Bank*

> "Lack of commitment to pay for performance by higher-level management."
> —*A Primary Metals Company*

> "I'm not certain 'pay for performance' for individual managers is a sound compensation strategy. It has a nice flavor, but the complications of setting goals and priorities and measuring results (and, perhaps, how they are achieved) is, at best, an imprecise and subjective process."
> —*A Consumer Products Manufacturing Company*
> (This was the only statement made in the survey "against" pay for performance.)

> "Budget constraints and forced distribution do not lead to a good pay-for-performance system."
> —*An Office Products Manufacturing Company*

Very Successful Pay-for-Performance Systems

As shown in Table 5 (page 7), 26 percent of the companies answering the question said their pay-for-performance efforts had been "very successful." Detailed questionnaire information was available on the compensation and performance-appraisal processes in 88 of these 94 companies.

In an attempt to identify any major differences between the companies reporting very successful programs and those reporting unsuccessful programs, a question-by-question analysis was made of the two sets of survey responses. (Of the total of 83 companies reporting unsuccessful programs, detailed questionnaire information was available for 80.) Approximately the same number of companies was involved: 88 very successful and 80 unsuccessful. The proportions from each of the four industry categories were:

	Very Successful	*Unsuccessful*
Manufacturing	47 (53%)	52 (65%)
Banking	25 (28%)	17 (21%)
Insurance	13 (15%)	10 (13%)
Diversified finance	3 (3%)	1 (1%)
Total	88 (100%)	80 (100%)

Table 25: Problems Occurring Frequently in Administering Pay for Performance, by Industry Category

Problem	Number of Mentions in Each Industry Category				Total Mentions
	Manufacturing	Banking	Insurance Companies	Diversified Financial Companies	
Lack of consistency	87	40	24	3	154
Overuse of middle categories	81	22	21	3	127
Failure to use system correctly	31	13	10	2	56
Too many high ratings	27	21	8	—	56
Performance objectives not clear	25	17	6	2	50
Overemphasis on external factors	24	3	8	—	35
Employee perceptions and expectations	21	11	14	2	48
Overemphasis on internal factors	11	11	6	1	29
Too few low ratings	8	5	3	—	16
Too many policy exceptions requested	2	2	1	—	5

As measured by number of U.S. employees, number of exempt employees, and financial criteria, the sizes of the very successful and unsuccessful groups were quite similar (Table 26).

In the question-by-question analysis, there was almost no apparent difference in the components of either the compensation or performance-appraisal systems between those perceiving their pay-for-performance program as very successful and those perceiving it as a failure. Thus, no particular practice or practices could be identified as clearly distinguishing the very successful program from the unsuccessful one.

There were a few instances where more than 10 percentage points separated the very successful programs from those that failed. The specific items were:

- More of the companies with very successful systems used the Hay (or a modification) job-evaluation method, while more of those with unsuccessful systems used other point-factor methods.
- More of the companies with unsuccessful programs had performance-related compensation plans, other than the salary program, which included exempt employees.
- More of the companies with very successful programs had formal performance-appraisal systems for determining exempt merit increases.

Since the components of the very successful and unsuccessful programs were virtually indistinguishable and considerable emphasis had been given by survey respondents to the importance of the ways in which managers use the system, a comparison was made to see if criticisms of system users were more prevalent among companies with unsuccessful programs. Again there was almost no difference between the two groups of companies on this point.

Therefore, the difference between pay-for-performance success and failure may very well depend on the perceptions and expectations of those commenting on their systems and may be a product of their individual standards and their conditioning by the particular corporate culture in which they work. Like beauty, pay-for-performance success or failure may ultimately lie in the eye of the beholder.

Table 26: Size of Companies with Very Successful Pay-for-Performance Systems and Companies With Unsuccessful Pay-for-Performance Systems

Industry Category	Average Number of Employees	
	Very Successful Systems	Unsuccessful Systems
Manufacturing	16,000	17,000
Banking	3,000	3,000
Insurance	2,000	3,000
Diversified finance	*	*

Industry Category	Average Number of Exempt Employees	
	Very Successful Systems	Unsuccessful Systems
Manufacturing	4,000	5,000
Banking	800	1,000
Insurance	900	1,000
Diversified finance	*	*

Industry Category	Average 1982 Sales Volume, Total Deposits, Premium Income (millions)	
	Very Successful Systems	Unsuccessful Systems
Manufacturing	$2,500	$2,237
Banking	3,140	3,465
Insurance	468	567
Diversified finance	*	*

*Insufficient data.